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Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-375

WILLIAM OTTE, Trustee in Bankruptcy of FREEDOMLAND, INC.,

Petitioner,

v.

UNITED STATES OF AMERICA and THE CITY OF NEW YORK,

Respondents.

BRIEF OF RESPONDENT, THE CITY OF NEW YORK

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Statement

On petition of the Trustee in Bankruptcy of Freedomland, Inc., this Court granted a writ of certiorari (100a)* to the United States Court of Appeals for the Second Circuit. The decision of that Court, which is under review, held:

1. That a trustee in bankruptcy on payment of wage claims entitled to priority under subdivision 2 of Section 64a of the Bankruptcy Act (11 U.S.C. § 104), is required to withhold from payment, federal withholding taxes pursuant to Sections 3402 (income tax) and 3102

* Unless otherwise indicated, references in parentheses are to pages of the Appendix.

(tax on employees, Federal Insurance Contributions Act) of the Internal Revenue Code as well as amounts required to be withheld pursuant to the Administrative Code of the City of New York, Sections T46-51.0 (City personal income tax on residents) and U46-8.0 (earnings tax on nonresidents);

2. That the trustee is also required to prepare and file with the taxing authorities the requisite returns and forms with a report of the withholding taxes;

3. That the claims for withholding taxes against the bankrupt estate were entitled to second priority wage claim status; and

4. That proofs of claim other than those filed by the wage claimants were not necessary for the withholding taxes involved.

Reported below: 480 F. 2d 184 (1973); 341 F. Supp. 647 (1972).

Statutes Involved

The federal withholding tax on wages is governed by Chapter 24 of the Internal Revenue Code (26 U.S.C. §§ 3401 to 3404). Subsection (a) of Section 3401 defines "wages" as follows:

> "For purposes of this chapter, the term 'wages' means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash;"

Paragraph (1) of subsection (d) of that Section which defines "employer", provides that:

> "[I]f the person for whom the individual performs or performed the services does not have control of the

payment of the wages for such services, the term 'employer' (except for purposes of subsection (a)) means the person having control of the payment of such wages,"

The tax is imposed by Section 3402 of the Internal Revenue Code, subsection (a) of which reads in pertinent part as follows:

"Requirement of Withholding.—Every employer making payment of wages shall deduct and withhold upon such wages (except as otherwise provided in this section) a tax determined in accordance with the following tables. For purposes of applying such tables, the term 'the amount of wages' means the amount by which the wages exceed the number of withholding exemptions claimed, multiplied by the amount of one such exemption as shown in the table in subsection (b)(1):"

The federal withholding tax relating to social security (FICA) is governed by Internal Revenue Code Chapter 21 (Federal Insurance Contributions Act). Section 3101 of that Code imposes the tax and presently reads, in pertinent part, as follows:

"(a) Old-Age, Survivors, and Disability Insurance. —In addition to other taxes, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b))—*

* * * *

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* The percentages which follow here vary greatly between the year 1964, when the wages in question were earned, and the present time. There is also a variance in income tax withholding rates within that period as well as in New York City tax rates.

(b) Hospital Insurance.—In addition to the tax imposed by the preceding subsection, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b))—"*

Section 3102 of that Code, subsection (a), reads, so far as pertinent, as follows:

"The tax imposed by section 3101 shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid."

Section 3121(a) of that Code defines wages as "all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash;"

Subsection (a) of Section 31 of the Internal Revenue Code reads as follows:

"(a) Wage withholding for income tax purposes.—

(1) In General.—The amount withheld under section 3402 as tax on the wages of any individual shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle.

(2) Year of credit.—The amount so withheld during any calendar year shall be allowed as a credit for the taxable year beginning in such calendar year. If more than one taxable year begins in a calendar year, such amount shall be allowed as a credit for the last taxable year so beginning."

Subsection (a) of § 7501 of that Code reads as follows:

"Whenever any person is required to collect or withhold any internal revenue tax from any other

* This additional tax was not in force when the wages were earned in 1964. It became effective in 1968 and its rates increased in 1973 with further increases for later years.

person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose."

The withholding tax requirement of the New York City personal income tax on residents (Title T of Chapter 46 of the Administrative Code of the City of New York) is set forth in subdivision (a) of § T46-51.0 of that Code and reads, so far as pertinent, as follows:

"On or after the first payroll period beginning forty-five days after the date this title becomes effective, every employer maintaining an office or transacting business within this state and making payment of any wages taxable under this title shall deduct and withhold from such wages for each payroll period a tax computed in such manner as to result, so far as practicable, in withholding from the employee's wages during each calendar year an amount substantially equivalent to the tax reasonably estimated to be due under this title resulting from the inclusion in the employee's city adjusted gross income of his wages received during such calendar year. The method of determining the amount to be withheld shall be prescribed by regulations of the administrator with due regard to the city withholding exemptions of the employee and the sum of any credits allowable against his tax. This section shall not apply to payments by the United States for service in the armed forces of the United States."

A similar withholding provision for the New York City earnings tax on nonresidents, Title U of the Administra-

tive Code, is contained in § U46-8.0 and reads as follows:

> "On or after the first payroll period beginning forty-five days after the date this title becomes effective every employer maintaining an office or transacting business within this state and making payment of any wages taxable under this title shall deduct and withhold from such wages for each payroll period a tax computed in such manner as to result, so far as practicable, in withholding from the employee's wages during each calendar year an amount substantially equivalent to the tax reasonably estimated to be due from the employee under this title. The method of determining the amount to be withheld shall be prescribed by regulations of the administrator."

New York City Administrative Code § T46-53.0 provides as follows for the income tax on residents:

> "Wages upon which tax is required to be withheld shall be taxable under this title as if no withholding were required, but any amount of tax actually deducted and withheld under this title in any calendar year shall be deemed to have been paid to the administrator on behalf of the person from whom withheld, and such person shall be credited with having paid that amount of tax for the taxable year beginning in such calendar year."

Similar provisions relating to the earnings tax on nonresidents are found in § U46-10.0 of that Code and read as follows:

> "Wages upon which tax is required to be withheld shall be taxable under this title as if no withholding were required, but any amount of tax actually deducted and withheld under this title in any calendar year shall be deemed to have been paid on behalf of

the employee from whom withheld, and such employee shall be credited with having paid that amount of tax in such calendar year. For a taxable year of less than twelve months, the credit shall be made under regulations of the administrator."

Section T46-55.0 (income tax) and § U46-12.0 (earnings tax) of the Administrative Code both provide that:

"* * * Any amount of tax actually deducted and withheld under this title shall be held to be a special fund in trust for the city."

Section T46-1.0(c) of the New York City Administrative Code provides that:

"Unless a different meaning is clearly required, any term used in this title shall have the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes, and any reference in this title to the internal revenue code, the internal revenue code of nineteen hundred fifty-four or to the laws of the United States shall mean the provisions of the internal revenue code of nineteen hundred fifty-four, and amendments thereto, and other provisions of the laws of the United States relating to federal income taxes, as the same are included in the appendix to this title."

The analogous provision in the City earnings tax on non-residents is contained in subdivision b of § U46-1.0 of the Administrative Code and reads as follows:

"'Payroll period' and 'employer' mean the same as payroll period and employer as defined in subsections (b) and (d) of section thirty-four hundred one of the internal revenue code of nineteen hundred fifty-four * * *."

The following portions of § 64a of the Bankruptcy Act, 11 U.S.C. § 104(a) are involved:

"Sec. 64a.—The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be

(1) The costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition; the fees for the referees' salary and expense fund; the filing fees paid by creditors in involuntary cases or by persons other than the bankrupts in voluntary cases; where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, is recovered for the benefit of the estate of the bankrupt by the efforts and at the cost and expense of one or more creditors, the reasonable costs and expenses of the recovery; the trustee's expenses in opposing the bankrupt's discharge or in connection with the criminal prosecution of an offense punishable under chapter 9 of title 18 of the United States Code, or an offense concerning the business or property of the bankrupt punishable under other laws, Federal or State; the fees and mileage payable to witnesses as now or hereafter provided by the laws of the United States, and one reasonable attorney's fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the bankrupt in voluntary and involuntary cases, and to the petitioning creditors in involuntary cases, and if the court adjudges the debtor bankrupt over the debtor's objection or pursuant to a voluntary petition filed by the debtor during the pendency of an involuntary proceeding, for the reasonable costs and expenses incurred, or the reasonable disbursements made, by them, including but not limited to compensation of

accountants and appraisers employed by them, in such amount as the court may allow. Where an order is entered in a proceeding under any chapter of this Act directing that bankruptcy be proceeded with, the costs and expenses of administration incurred in the ensuing bankruptcy proceeding, including expenses necessarily incurred by a debtor in possession, receiver, or trustee in preparing the schedule and statement required to be filed by sections 238, 378, or 483, shall have priority in advance of payment of the unpaid costs and expenses of administration, including the allowances provided for in such chapter, incurred in the superseded proceeding and in the suspended bankruptcy proceeding, if any;

(2) Wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt; and for the purposes of this clause, the term 'traveling or city salesman' shall include all such salesmen, whether or not they are independent contractors selling the products or services of the bankrupt on a commission basis, with or without a drawing account or formal contract;

* * * *

(4) Taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however,* That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further,* That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court;"

Questions Presented for Review

This case raises the following questions:

1. Is a trustee in bankruptcy, when he pays pre-bankruptcy wage claims, required to withhold, report and pay withholding taxes under Internal Revenue Code (26 U.S.C.) § 3401 (income tax) and § 3101 (FICA), and the New York City counterparts of the income tax provisions, Administrative Code § T46-51.0 (income tax on residents) and § U46-8.0 (earnings tax on nonresidents)?

2 If so, do these withholding taxes enjoy priority status as wage claims under Bankruptcy Act § 64a(2), tax claim status under subdivision (4) of that section, or administration expense status under subdivision 1 of that section?

3. Is it necessary for the taxing authorities to have filed proofs of their claims for these withholding taxes within the period provided in Bankruptcy Act § 57n when the taxes do not become due and their amounts cannot be ascertained until the wage claims are actually paid?

Statement of the Case

The bankrupt filed a petition for an arrangement on September 15, 1964 and was adjudicated a bankrupt on August 30, 1965 (6a).

Four hundred and thirteen former employees of the bankrupt filed timely claims for wages due them before the petition for arrangement (30a).

Neither the United States nor the City of New York filed proofs of claim for the withholding taxes which they claim will become due upon the payment of the wage claims (71a-72a).

On motion of the trustee, the referee in bankruptcy entered an order authorizing the trustee to pay the wage claims without withholding any federal income and social security taxes, any New York State or New York City withholding taxes for income tax or earnings tax or any other payroll taxes (48a-50a).

Petitions to review that order were filed by the United States of America and the City of New York. The United States District Court for the Southern District of New York reversed the order of the referee so far as it pertained to federal taxes, directed withholding of federal taxes but ordered that the amounts withheld be paid only as fourth priority tax claims under Bankruptcy Act § 64a(4) (92a). The Court denied the petition of the City of New York (*Ibid.*), thus denying it any withholding tax payments, on the ground that the New York City tax laws were enacted in 1966 and were not effective in 1964 when the wages in question became due (90a-91a).

The trustee, the United States and the City appealed from the District Court's order to the United States Court of Appeals (5a-6a), which affirmed in part and reversed in part the holding of the District Court (3a-4a), holding that a trustee must withhold, report and pay over the withholding taxes on the wage claims, that the United States and the City were entitled to be paid as second priority wage claimants under § 64a(2) and that the taxing authorities were not required to file proofs of claim because the filing of the wage claims constructively constituted a claim for that portion of the wage claims required to be withheld (5a-17a).

The Opinion Below

The opinion of the Court of Appeals first dealt with the question of whether moneys paid to wage claimants were wages within the Internal Revenue Code definition which also applied to the New York City taxes. It held

that, since that definition included all remuneration for services performed by an employee for his employer, it included amounts distributed to bankruptcy wage claimants. It also pointed out that the Internal Revenue Code definition of "employer" included the trustee as a person having control of the payment of wages. In drawing these conclusions, the Court followed the case of *United States* v. *Fogarty,* 164 F. 2d 26 (8th Cir., 1947), and pointed out that that case had been followed in the Third, Sixth and Ninth Circuits.

The Court next disposed of the trustee's complaint about excessive computations, employment of accountants, completion of forms and other work entailed in paying withholding taxes by pointing out that "[t]he trustee's and referee's parade of horribles * * * was quite deflated by the [District] court below in its findings * * *" to the effect that the work entailed could be handled by a payroll clerk, bookkeeper or other clerical employee and "adds only slightly to the trustee's inescapable task and cost of verifying each claim before payment" (11a).

It next took up the question of priorities and concluded that the taxes in question could not be considered as administration expenses because then they would take priority over the wages on which they were based. Nor could the Court see classification as a fourth priority claim as taxes which became legally due and owing by the bankrupt because these taxes did not become due and owing and would not become due and owing until the wage claims were paid by the trustee and consequently were never due and owing by the bankrupt. It then concluded that, because the taxes in question were carved out of and deducted from the wage claims to which they related, and the wage claimants credited with the amounts withheld, conceptually the taxes should be treated in the same way as the wages from which they derived and of which they are a part. It then adverted to Internal Revenue Code

§ 7501 and its New York City analogues which provide for trust fund status for withheld taxes. It took the position that when wage claims are ordered to be paid, the withheld taxes should be segregated and held as trust funds. In stating this view, the Court did not imply that the segregated moneys had the kind of trust fund status which took precedence over administration expenses but rather viewed the trust which arises from the act of segregation as subject to the prior payment of costs and expenses of administration.

Finally, it expressed the hope that either Congress or this Court would resolve the conflict concerning priorities which existed among the different Circuits (17a).

Summary of Argument

I

The trustee in bankruptcy should be required to withhold federal income and social security taxes, as well as New York City income and earnings taxes, when he makes a distribution of wage claims. The wage claim payments are wages within the meaning of the federal and city statutes that require withholding from wages [I.R.C. (26 U.S.C.) Sections 3401(a) and 3121(a); Administrative Code of the City of New York, Sections T46-51.0(a) and U46-8.0]. While the trustee was not the employer of the wage claimants, for purposes of the taxes in question he is denominated an employer by subsection (d) of Section 3401 of the Internal Revenue Code, since he is "the person having control of the payment of such wages."

The fact that the payment of withholding taxes and the preparation of the various reports that accompany that payment may impose a burden and expense on the trustee and his estate does not justify freeing him from the obligations imposed by the various taxing laws. The addi-

tional work entailed was found, as a fact, to have been considerably less than that which was described by the trustee. But whether great or small, the work involved in the reporting and the paying of taxes required by law is an essential duty of the trustee.

II

The claims for withholding taxes will be satisfied by amounts carved out of and derived from the wages to which they relate. In a very real sense, they are not payments to the taxing authorities but payments to the wage claimants who are credited with their amounts by the taxing authorities. Indeed, they may ultimately be refunded to these wage claimants if other credits against their taxes equal or exceed those taxes. Because these withholding taxes are deducted from the wages of which they are a part, the taxes conceptually constitute wages. Accordingly, they are to be classified for purposes of determining priorities in distribution by the trustee, as wage claims, as the Court below properly held. They cannot be classified as tax claims because they were not taxes due and owing from the bankrupt. To consider them as administration expenses raises a problem in calculating the amount of moneys available for payment of wage claims. In order to determine that amount, administration claims must first be ascertained. But if the taxes are considered as expenses of administration, and cannot be calculated until the amount available for wage claims is determined, we are presented with a mathematical problem which is insoluble.

III

It was not necessary for the taxing authorities to file proofs of claim for these taxes. Indeed, it was not possible to file an accurate proof of claim because the extent of the taxes involved could not be determined until the actual payment of the wage claims. The taxes do not become due

until that payment is made and since the rates of tax change from time to time, the filing of a claim setting forth the maximum possible tax is not feasible. Indeed since there are no taxes due until the actual wage claim distribution is made, there is no claim until that time, which is long after the period for filing creditor's proofs of claims has expired.

Since the tax payments are actually payments of wages, the filing of the wage claims by the wage claimants for the full amount of wages to be paid, which claims included the amount of the taxes in question, was sufficient to constitute claims on behalf of the taxing governments. The fiilng of an estimated maximum tax claim would not be helpful in the administration of the estate, because the amounts of those tax claims were already included in the claims filed by the wage earners.

ARGUMENT

POINT I

A trustee in bankruptcy who makes a payment of wage claims is required to withhold and pay federal and New York City withholding taxes.

(1)

The Court below concluded that the trustee was obligated to withhold income and social security withholding taxes upon making payment of wage claims. In so holding the Court followed a line of precedents beginning with *United States* v. *Fogarty,* 164 F. 2d 26 (8th Cir., 1947). *In re Connecticut Motor Lines, Inc.,* 336 F.2d 96 (3rd Cir., 1964); *United States* v. *Curtis,* 178 F.2d 268 (6th Cir., 1949), cert. den. 339 U.S. 965 (1950); *Lines* v. *State of California, Department of Employ.,* 242 F.2d 201 (9th Cir., 1957), rehearing den. with opinion 246 F.2d 70 (9th Cir., 1957) cert. den. 355 U.S. 857 (1957); *In re Daigle,* 111 F. Supp. 109

(D.C. Me., 1953). It pointed out that "[w]hile *Fogarty* and its fellows have been criticized sharply by writers in the bankruptcy field, there is no decision of any court outstanding to the contrary on the point of necessity of withholding" (10a).

The theoretical underpinning of the holdings in this case and the *Fogarty* case is simple and sound. The courts held that wage claim payments are wages within the meaning of the federal statutes requiring withholding from wages. That is, they are "remuneration * * * for services performed by an employee for his employer" [I.R.C. (26 U.S.C.) § 3401(a)] and "remuneration for employment" [I.R.C. (26 U.S.C.) § 3121(a)].

While the services in question in *Fogarty* and those in question here were performed for the bankrupt and not for the trustee, they were nevertheless performed for an employer. When it came to liability for the tax which was laid upon the employer by the statute, the Court in *Fogarty* held that the trustee stood in the bankrupt employer's shoes. Moreover, as to the income withholding taxes, it held the trustee to be within the statutory definition of "employer" as did the Court below (10a). The tax law applicable in *Fogarty* provided, as does § 3401(d)(1) of the Internal Revenue Code, that "if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term 'employer' * * * means the person having control of the payment of such wages * * *."

The same rationale applies to the City withholding taxes for they are imposed upon the payment of wages by an employer (Admin. Code §§ T46-51.0(a) and U46-8.0) and the terms "wages" and "employer" used in the City laws are deemed by those laws, to have the same meanings as those terms as defined in the Internal Revenue Code. Admin. Code, §§ T46-1.0(c) and U46-1.0(b) and (e). Consequently the same rule governs the question of the trustee's liability for both the federal and the City withholding taxes.

The taxes in question—as we shall show at greater length in Point II, *infra*,—do not become due and owing and are not payable until the wage claims are actually paid. Hence, they never were the bankrupt's obligation, even though the wages were. The taxes are the primary obligation of the person making payment of the wages or wage claims, in this case the trustee. He is the taxpayer and as trustee he is liable for the tax and is required to withhold its amount. See *Nicholas* v. *United States*, 384 U.S. 678, 692-693 (1966); *Boteler* v. *Ingels*, 308 U.S. 57 (1939). *Cf.* 28 U.S.C. § 959(b) and § 960.

(2)

The trustee, however, would have this Court free him from the duty of withholding, reporting and paying taxes on wage claim distributions in bankruptcy (Pet's Br., pp. 8-11). In the course of his argument, he urges a number of points upon this Court and cites various authorities in support of them. We shall discuss them briefly.

He cites two revenue rulings, Rev. Rul. 69-136, 1969-1, Int. Rev. Bull. 252, 253 and Rev. Rul. 55-520, 1955-2, Int. Rev. Bull., 393-394, in support of his position (Pet's br., p. 9). The rulings are inapposite, for the payments involved were not wages, *i.e.*, "remuneration • • • for services performed" [I.R.C. § 3401(a)]. The first did not even deal with employees but with former employees in military service who were given an amount to make up their loss of earnings while in service. The second dealt with an amount paid for cancellation of an employment contract.

While the bankrupt was the employer of the wage claimants and the trustee is not their employer, for purposes of liability for the tax involved the trustee is specifically denominated an employer by subsection (d) of § 3401 of the Internal Revenue Code as "the person having control of the payment of such wages." On this score, the trustee argues that he does not have such control because payment

requires an order of the bankrupicy court and the Court itself may send out the dividend checks (Pet's Br., pp. 9-10). But it is generally the trustee who applies for that order [as he did in this case (48a-50a)] and it is the trustee who must sign the checks which he submits for the Referee's countersignature and who, as trustee, has title to the funds to be paid. After the order is signed, he surely has control. That he may share control to a very limited extent with the Court and the Referee does not alter his status as an "employer."

The trustee criticizes *Fogarty* and its result because the Court in that case relied on *Social Security Board* v. *Nierotko*, 327 U.S. 358 (1946), and *Nierotko* "had no Bankruptcy Act overtones" (Pet's Br., p. 10). *Nierotko* held that back pay ordered by the National Labor Relations Board of a wrongfully discharged employee was "wages" entitling the employee to credit for old age benefits under the Social Security Act. We are unable to see why the absence of bankruptcy "overtones" makes the case inappropriate as a precedent supporting the decision in *Fogarty*. It dealt with an analogous and unconventional payment. Certainly it was not cited as the sole foundation for the decision.

The trustee then goes on to assert that this Court reached a conclusion "diametrically opposed" to *Nierotko* in the bankruptcy case of *U.S.* v. *Embassy Restaurant*, 359 U.S. 29 (1959). That case held that contributions due from an employer to a union welfare fund pursuant to a collective bargaining agreement were not wages entitled to wage claim priority under § 64a(2) [11 U.S.C. § 104(a)(2)] of the Bankruptcy Act. The *Nierotko* case and the *Embassy* case are not in opposition. The difference in result is not explained by the presence or absence of a bankruptcy setting. They were miles apart in factual content. In *Nierotko* the claimant was the employee and the subject was pay; in *Embassy* the claimant was a third party bene-

ficiary of a collective bargaining agreement, the subject of the claim was its right, not the employee's right, to payments from the bankrupt.

Nor is the trustee's attempt to demonstrate that *Educational Fund of Electrical Industry* v. *United States*, 426 F. 2d 1053 (2d Cir., 1970), is not relevant to the issue because it did not involve a bankruptcy, sound. The case was appropriately cited by the Court below (19a) to indicate the broad sweep of the provision of the Internal Revenue Code defining "employer" as one having control of the payment of wages.

(3)

The trustee espouses the view that the ruling of the Court below that withholding taxes should be paid by a trustee on pre-bankruptcy wages is unsound or, at least, unsound if applied to all bankruptcy cases (Pet's Br., pp. 20-22). It is argued that to require the trustee to withhold the taxes, pay them, and file and furnish the requisite returns and information forms would impose an excessive burden and expense on him and a diminution of the funds available for other creditors. He urges that this would be inconsistent with the letter and spirit of the Bankruptcy Act.

We can find nothing in the Bankruptcy Act which exempts the trustee from performing duties of administration required by statutes merely because there would be less expense and less work if he did not perform these duties. Nor do we think that the spirit of the Act alluded to applies, where economy is bought at the expense of tax claimants. Essentially this argument suggests that tax laws may place an onerous duty upon ordinary taxpayers, but, when those taxpayers happen to be trustees in bankruptcy, that duty should be remitted.

We think that the trustee has in mind the general rule of administrative economy applicable to fees and

allowances in bankruptcy [3A COLLIER ON BANKRUPTCY, pp. 1429-1430 (14th Ed., 1940); 1 REMINGTON ON BANKRUPTCY, pp. 58-61 (5th Ed., 1950)] and the need to preserve as much of the bankrupt estate as possible for creditors. This, however, does not mean that statutory duties may be avoided and that the rights of creditors may be disregarded.

Tax authorities are as much creditors as are general creditors; indeed they are creditors with a preferred status. The kind of economy sought here by the trustee would not benefit all classes of creditors, and it is that which should be the aim of economical administration. Moreover, were the trustee's view to prevail it would work injury to the wage claimants for their credits for old age benefits would be lessened by failure to pay the F.I.C.A. withholding taxes, a failure they could not make up by voluntary self-payment. See *United States* v. *Fogarty*, 164 F 2d 26, 29 (8th Cir., 1947).

The task of a trustee of a bankrupt estate is to administer that estate. True, he should do so as efficiently as possible. But, if in the course of administration, he comes upon an arduous task, it is nevertheless his duty to perform it. It may be that the work involved is more costly than the benefits to be derived by the beneficiaries of the undertaking. If this is his concern, he may, and should, seek amelioration by agreement or compromise with those beneficiaries. In the instant case, the United States government has offered to ease the trustee's task by permitting him to compute taxes at an estimated 25% (8a, 65a, 68a). The City made a similar gesture (90a), a gesture which it will adhere to despite the increase in rate of tax which occurred after the concession was made. (See *infra*, pp. 30-31)*

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* The trustee seems to complain of having his burden lightened in this manner (Pet's br., p. 22). If this is so, we have no objection to the use of actual rates.

We believe that, as a matter of law, the argument of excessive burden is wholly without merit and irrelevant. Nevertheless, the District Court took evidence on the question of administrative difficulty (77a) and concluded that the trustee's claims in this regard were considerably exaggerated (79a-81a).

In support of this argument the trustee (Pet's br., p. 21) cites 3A COLLIER ON BANKRUPTCY, pp. 1429, § 62.05(1) and 1396, § 62.02(1) (14th Ed., 1940). The citations are not in point. The subjects dealt with in the text are the general principles governing fees and allowances and their judicial control, and of course, here there are numerous cases dictating the "principle of economy" in those areas. *In re Berneddy's Inc.*, 108 F. Supp. 183 (D.C. Mass., 1952), aff'd *sub nom. Commonwealth of Massachusetts* v. *Widett*, 204 F.2d 512 (1st Cir., 1953), cited by the trustee (*ibid.*), is not analogous to our case. In that case, the Court refused to direct the trustee to prepare certain State employment reports. It stated, in effect, that it would be unfair and improper to eat up the few funds on hand to provide information which the State authorities could readily obtain by examining the bankrupt's books. But the important fact to be noted is that the Massachusetts law involved did not require the trustee to file the report in question. 108 F. Supp. at p. 184.

(4)

The trustee does not state whether the rule of economy for which he contends is a rule of general application or one applicable only where the burden of compliance with the tax law is in fact excessive. If not of general application, such a rule would require the resolution of factual questions in every case where wage claims were involved, the resolution of which would inevitably result in disharmonious decisions among the varying cases in which they were raised.

On the other hand, if the rule is to be one of general application so that, withholding taxes need never be paid by a trustee, it would mean that the tax would be excused in every case simply because in some cases payment and the accompanying duties might be onerous and expensive.

In the present case, the trustee points to the fact that he will have to prepare returns for $80,000 in priority wage claims, with names, addresses, social security numbers and withholding exemptions of the claimants, and that such information is contained somewhere in 42 filing cabinets located in a warehouse (Pet's. br., pp. 4-6). While it is likely that the bankrupt, which was a large modern corporation, had adequate payroll records, there is no doubt that the task involved does call for effort. But treating the rule sought as one of general applicability would mean that it would also apply to a bankrupt who had only one or two employees with records readily available or easily obtained, in which case the work involved would be truly negligible.

The fact is that the tax reporting work involved in the instant case is not disproportionate to the size of the corporate bankrupt, and it involves little more than the bankrupt itself would have been required to perform in the ordinary course of its business.

POINT II

The claims for withholding tax should be accorded priority as second priority wage claims. If taxes are properly withheld and segregated, they will be trust claims within that second priority category.

(1)

Classifying the claims of the taxing authorities for purposes of determining their place in the scheme of priorities involves a somewhat unusual problem. They do not facilely

fit into any of the various classes of claims described in Bankruptcy Act § 64a (11 U.S.C. § 104). It can be reasonably argued that they can be viewed as wage claims, trust claims or administration claims. But the one classification that they cannot possibly fit into is that of fourth priority tax claims.*

Classification has proven troublesome for the Courts. There is a three-way conflict among five circuits (17a). *Cf. U.S.* v. *Fogarty, supra,* 164 F. 2d 26 (8th Cir., 1947) (administration expense); *Lines* v. *State of California, Department of Employ.,* 242 F. 2d 201 (9th Cir., 1957), rehearing den. with opinion, 246 F. 2d 70 (9th Cir., 1957), cert. den. 355 U.S. 857 (1957) (administration expense); *United States* v. *Curtis,* 178 F. 2d 268 (6th Cir., 1949), cert. den. 339 U.S. 965 (1950) (administration expense); *In re Connecticut Motor Lines, Inc.,* 336 F. 2d 96 (3rd Cir., 1964) (fourth priority taxes); and the instant case, *In re Freedomland, Inc.,* 480 F. 2d 184 (2nd Cir., 1973) (wage claims).

We believe that the proper classification for these claims is that of second priority wage claims. As such, if the trustee handles the withheld taxes as he should, they will also partake of the nature of trust claims—not trust claims superior to administration expenses—but trust claims nevertheless, *for* they are held in trust for the taxing authorities.

(2)

All of the withholding taxes, federal and City, are deducted from and carved out of the payments made to the wage claimants. I.R.C. (26 U.S.C.) § 3401 and § 3101; Admin. Code § T46-51.0 and § U46-8.0. The wage claimants are credited on account of their income taxes with the withheld amounts. I.R.C. (26 U.S.C.) § 31(a); Admin. Code

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* Even the trustee agrees that this is so (Pet's br. pp. 15-16).

§ T46-53.0 and § U46-10.0. Analytically and actually the tax payments constitute a deducted part of the wages of the claimant. They are included in his gross income for income tax purposes as wages and may not be deducted from it. I.R.C. (26 U.S.C.) § 275(a)(1)(A) and (C); Admin. Code § T46-53.0 and § U46-10.0. Instead of being paid directly to the wage earner, they are paid to the taxing authorities for his account. The amount of his wage claim distribution is diminished by their amount. The wage distribution to him is reduced, but the tax authorities receive the balance on his behalf. He may even obtain a refund of the amount withheld if other credits equal or exceed his income tax liabilities. If he receives wages —and he does—the withheld amounts paid to the governments and carved out of his gross wages are also his wages. The tax payments have their genesis in the wages from which they are deducted and derived. Since classification is necessary, the claims of the tax authorities are wage claims, for it is only from wage claim distributions that they are derived and paid.

If the trustee is required to withhold taxes upon payment of the wage claims, the bankruptcy court should and, we believe, will direct him to segregate the amounts withheld* and pay them over to the taxing authorities for which he is the collecting agent. The amounts segregated actually are paid to the taxing authorities on behalf of the wage claimants who are credited with them whether or not the government receives them [I.R.C. (26 U.S.C.) § 31]. Not only does the law provide that they constitute trust funds [I.R.C. (26 U.S.C.) § 7501(a); Admin. Code § T46-55.0 and § U46-12.0] but even without those provisions they are trust funds when they have been segregated. They are taxes collected on behalf of a government, and the trustee, in collecting them by withholding them, is an agent of

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* Cf. Bankruptcy Rules for the Southern and Eastern Districts of New York, Rule XI-5.

the government and holds them, as any other agent holds his principal's funds, in trust.

Nothing that was said or passed upon in *United States* v. *Randall,* 401 U.S. 513 (1971), changes this. In that case, as this Court pointed out, the taxes had never been set aside. There was no trust *corpus* (401 U.S. at p. 515).

Ordinarily, trust claims come before administration expenses. *City of New York* v. *Rassner,* 127 F.2d 703 (2nd Cir., 1942). But the present trust claim cannot enjoy that kind of priority because it is, or will be, a trust which arises upon the payment of and out of the proceeds of a wage distribution which enjoys only a second priority after administration expenses. Moreover, in order to determine the amount of assets available to pay wage claims, all prior claims, including not only administration expenses but those trust claims having super priority, must be calculated. The fact, however, that the claims in issue are not the ordinary kind of trust claims does not make them any less trust claims. Their status as trust claims inheres in their very nature because they are monies set aside after they are carved out of and withheld from distributions made by the trustee.

It makes little difference, however, whether the claims are viewed as trust claims or as wage claims. The result is the same. They are paid only when there are sufficient assets to pay second priority wage claims. They are both trust claims and wage claims. There is nothing inconsistent in so viewing them.

(3)

In *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947), the question of priority status was examined and the Court held that the taxes on the wage claim payments were administration expenses entitled to priority under Bankruptcy Act § 64a(1) [11 U.S.C. § 104(a)(1)]. On its peculiar facts we believe that the *Fogarty* case may have been

correct on this point. However, its holding is not inconsistent with our contentions concerning the wage and trust claim status of the withholding tax claims in issue. For in *Fogarty,* there was no segregation of the taxes withheld. Indeed, it is not clear whether any were withheld. They were actually satisfied by setting their amounts off against a claim by the bankrupt against the United States for work performed in building vessels for the Navy.

Nevertheless, this aspect of the *Fogarty* case might be applicable to the case at bar if trust and wage claim status should be denied. The administration claim status of withholding taxes would then follow from the fact that they cannot be classified as taxes "which became legally due and owing by the bankrupt."

It is manifest that the obligations involved will be incurred by the trustee as part of his administration of the bankrupt estate. Part of that administration consists of his performing his duty to withhold these taxes and to pay them over to the proper authorities whenever wage claims are paid. This is an administration duty pure and simple.

The notion expressed in the trustee's brief (Pet's. br. pp. 17-18) and in *In re Connecticut Motor Lines, Inc.,* 336 F.2d 96, 100-101 (3d Cir., 1964), that to qualify as an expense of administration under subdivision (1) of Bankruptcy Act § 64a [11 U.S.C. § 104(a)], the expense must be in preservation of the estate, is a false one. Such preservation expenses are only a small part of the costs of administration which cover a far broader spectrum of expenditures and are not limited to the specific items mentioned in Bankruptcy Act § 64a(1) [11 U.S.C. § 104(a)(1)]. 3A COLLIER ON BANKRUPTCY, pp. 1419, 2093-2098 (14th Ed., 1940).

Nor are the withholding taxes in question the result solely of activities taking place before bankruptcy (Pet's.

br. p. 17). They result from and do not become due until the actual distribution of wage claims by the trustee.

We must, in candor, point out that classifying the claims in question as administration expenses involves an anomaly, for to compute the taxes, the amount payable to the wage claimants must be determined. Those amounts can only be determined by subtracting the sum of the administration expenses and any other higher priority obligations from the funds on hand in the bankruptcy estate. In making this calculation, obviously neither the wage claims nor the taxes on them can be included among the administration expenses. Thus, to consider the wage claims as administration expenses destroys the symmetry of the Bankruptcy Act's scheme of priorities and poses an insoluble mathematical problem.

(4)

The trustee asserts that requiring him to withhold taxes would be tantamount to the imposition of a penalty barred by Bankruptcy Act § 57(j) [11 U.S.C. § 93(j)] (Pet's. br. p. 19). He adverts to Internal Revenue Code (26 U.S.C.) § 6672, and N.Y.C. Administrative Code § U46-35.0(g) and (presumably) § T46-65.0(g), all of which impose a 100% penalty (distinct from and in addition to the tax) on persons who are required to collect, truthfully account for, and pay over withholding taxes and who wilfully fail to do so or who attempt to evade or defeat tax.

This case, however, does not involve any claim for a penalty by either the federal government or the City. The issue the trustee seeks to raise can only arise if the trustee wilfully fails to pay the withholding taxes or wilfully attempts to evade or defeat them.

POINT III

Proofs of claim, other than those for wage claims, were not necessary for the withholding taxes involved.

(1)

The Court below held that there was no requirement that the taxing authorities file proofs of claims for the taxes involved, because it might be impossible to do so until the amounts of wage claims are ascertained (16a). It held that "[t]he filing of the wage claims by the individuals constructively constituted a claim by the taxing authorities for withholdings due by law" (*ibid.*).

The trustee challenges that holding (Pet's. br. pp. 11-13). The challenge is without merit.

Obviously, the absence of claims is due to the fact that it is not possible to calculate a "maximum tax" even now. Moreover, it would not be possible to file a timely claim for withholding taxes. A withholding tax claim may be made only on the basis of wages claimed. Hence, it cannot be made until the wage claims are filed. Even if it were assumed that the tax rates would remain stable and that the funds would be adequate to pay all wage claims, the governments could not file their withholding tax claims until all wage claims had been filed. It cannot be certain that all are filed until the last day to file them. Then it is too late to calculate and file timely tax claims based on those wage claims.*

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* It is conceivable—though we do not assert that it happened in this case—that a withholding tax claimant would receive no notification of the bankruptcy. For Bankruptcy Act § 58(a) requires notice only to creditors and the United States District Director of Internal Revenue. In such a case the claimant could hardly be expected to file a proof of claim within the required period.

If we are correct in our view that these claims are entitled to wage claim status, no proofs of claim are necessary. The very filing of the wage claim by the wage claimants for the full amount of wages was sufficient to constitute a claim on behalf of the governments because the trustee and referee had before them claims which included the governments' withholding tax claims.

In the *Connecticut Motor Lines* case (336 F. 2d 96, 107), the Court not only found that the claim was a fourth priority tax claim, but disallowed it for failure to file a proof of claim. The consequenses of such a disposition are most inequitable.* The wage claims are reduced by the amount of the taxes withheld, but because no proof of claim was filed the taxing authority does not get those taxes. Nevertheless, the taxing authority cannot levy the tax on the wage claimants because they get full credit for the withholding regardless of the fact that the government has not been paid [I.R.C. (26 U.S.C.), § 31; see Admin. Code § T46-53.0]. The anomalous result was that the government was not paid the withholding taxes, the employees were nevertheless credited with payment of the amounts of the withholding taxes, and the amounts withheld were used to pay general creditors.

(2)

Proofs of claims must state that the claim is justly "owing from the bankrupt to the creditor" [Bankruptcy Act § 57a (11 U.S.C. § 93(a))]. The claims in question were never owing from the bankrupt and are not even owing at this time. The tax liability in question does not come into existence and does not accrue until wages or their equivalents are actually paid. The pertinent language of the New York City tax laws contained in Administra-

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* The Court was fully aware of the anomalous and astonishing results of its holding. See 336 F. 2d at p. 107.

tive Code §T46-51.0(a) and its Title U analogue states that an employer "making payment of any wages taxable under this title shall deduct and withhold from such wages for each payroll period a tax * * *." Payment, actual payment, is a precondition to the withholding and liability for these ttaxes.

The same is true of the federal taxes involved. Internal Revenue Code (26 U.S.C.) § 3402(a), states that "[e]very employer making payment of wages shall deduct and withhold upon such wages * * * a tax * * *." Section 3101 of the Internal Revenue Code (26 U.S.C.) which imposes the employee's share of social security tax, states that "there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages * * * *received by him* * * *" (italics supplied).

Concededly, the Court of Appeals for the Third Circuit reached a contrary conclusion in the *Connecticut Motor Lines* case. That case pointed out (336 F.2d at p. 105), in answer to the claim that the taxes could not be determined or accrue until wages were determined in amount and actually paid and hence could not be "due and owing by the bankrupt", that it was possible to compute both a "maximum wage due" from the bankrupt's records and a "maximum tax due."

No maximum tax, however, can possibly be computed. There is no assurance that the tax rates applicable to the wages will remain the same until the date the wage claims are paid. In this case, the rates did not remain the same and they may be changed again before payment of the wage claims is made. The tax rate at the time of payment of the wages governs.

The wages in question were earned in 1964 when federal individual income tax rates ranged from 16% to 77% [I.R.C. (26 U.S.C.) § 1, as amended by the Revenue Act of 1964, P.L. 88-272, § 111(a), 78 Stat. 19]. From 1965

through the present time, they have ranged from 14% to 70% [*id.*, Revenue Act of 1964 (P.L. 88-272, § 111(b), 78 Stat. 19)], with an intervening tax surcharge (P.L. 90-364, § 102, 82 Stat. 251; P.L. 91-53, § 5, 83 Stat. 91; P.L. 91-172, § 701, 83 Stat. 487).

The withholding rates, however, were subject to much more fluctuation and have increased considerably since the wages involved here were earned.*

The range of social security tax rates is, of course, even greater. They increased from a rate on employees of 3.625% in 1964 to their present rate of 5.85% [I.R.C. (26 U.S.C.) § 3101(a) and (b)].

The New York City taxes involved were increased for the taxable years beginning on or after January 1, 1971 [N.Y.C. Admin. Code, § T46-3.0 and § U46-2.0(a), as last amended by New York City Local Law No. 81 of 1972].

The trustee may have been misguided into assuming a more stable rate structure by the federal government's long standing practice of accepting, in bankruptcy proceedings, 25% as a withholding tax rate for all of its taxes (62a, 81a) and the City's statement in the present case that it will accept 1% (73a). These concessions were made for the sake of facilitating administration and not as *indicia* of the true liability of the trustee. They do not bear upon

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* Between March of 1964 and May of 1966, the withholding rate was 14% above exemptions [P.L. 88-272, § 302(b), 78 Stat. 19]. After May 1, 1966, the rates were placed on a progressive graduated scale running between 14% and 30% [P.L. 89-368, § 101(c), 80 Stat. 38]. After July 13, 1968, they were increased to a maximum of 33% [P.L. 90-364, § 102(c) 82 Stat. 251; P.L. 91-36, § 2(a)(2), 83 Stat. 42; P.L. 91-53, § 6(a)(2), 83 Stat. 91], then jumped to a range of 21% to 31% between January 1, 1970 and June 30, 1970 [P.L. 91-172, § 805(a), 83 Stat. 487], with the maximum rate dropping to 30% for the following half-year period (*ibid.*). For the year 1971, the rates were from 14% to 25% (*ibid.*) and then, beginning January 1, 1972, increased to 14% to 36% [P.L. 92-178, § 208(a), 85 Stat. 497].

the question of whether a maximum tax as of the time that the wages accrue is calculable. It is manifest, if only by reason of the fluctuation in tax rates, that no such projection can or could have been made.

The taxes were never "owing from the bankrupt" and could not have been calculated at the time the wages were earned. They will be due and may be calculated only when the wage claims are paid and not until then.

(3)

The basis of our argument here finds agreement in the trustee's brief. For in arguing against "fourth priority" status (Pet's. br. pp. 15-16), he states that the withholding taxes are not "owing by the bankrupt" and he points out (Pet's. br. p. 16) that the taxes cannot be due and owing until the wage claims are actually paid.

(4)

Each of the forms for proofs of claims which this Court has promulgated with its General Orders in Bankruptcy (Forms 28, 29, 30 and 31) requires a statement that "the • • • bankrupt, was at and before the filing by [*or* against] him of the petition for adjudication of bankruptcy, and still is, justly and truly indebted [*or* liable] to" the claimant. Such a statement could not possibly be subscribed by the taxing authorities here, for the bankrupt was never indebted to them for the withholding taxes.

CONCLUSION

The order of the United States Court of Appeals, for the Second Circuit, should be affirmed.

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